No. 15938

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

IRVING I. BASS, Trustee in Bankruptcy of Zipco, Inc., a corporation, Bankrupt,

Appellant,

vs.

ROBERT H. SHUTAN,

Appellee.

APPELLEE'S BRIEF.

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Statement of the Case.

The statement of the case as set forth by Appellant in Appellant's Opening Brief contains certain material inaccuracies of fact which somewhat distort the background of the claim herein, and therefore Appellee deems it necessary to set forth his own Statement of the Case.

This is an appeal from an Order of the District Court, which upon the hearing of the Petition for Review, reversed an Order of the Referee in Bankruptcy disallowing a prior claim asserted by Appellee.

Appellee, within the proper time, filed a priority claim in the within bankruptcy proceedings in the amount of $1531.45, said claim being based upon the ownership by claimant of payroll checks in said amount, being payroll checks of the bankrupt corporation for wages earned

within three months preceding the commencement of the subject bankruptcy proceedings. The verified proof of claim stated that the checks, for full and valuable consideration, were duly assigned to claimant, the Appellee. Exactly one year after said prior wage claim had been filed, the Trustee in bankruptcy filed an objection to said claim. The Trustee alleged on information and belief (1) that in fact no wages were assigned to claimant; (2) that the bankrupt and not the claimant paid the employees (and thereupon the subject checks became the property of the bankrupt who then assigned the checks to the claimant); (3) the Trustee also objected on the ground of lack of consent of the spouse of the wage earner; but counsel for the Trustee stated at the hearing on this matter that such objections appeared only through error in the written objections to claim [Tr. 44], and such objection was abandoned by the Trustee [Tr. 44, 62]; (4) the Trustee's objections stated the further ground that the subject claim was for legal services, was excessive and should be redetermined by the Referee. No other bases of objection was set forth by the Trustee.

Said objections to the subject claim were tried before the Referee on August 8, 1957; and a complete transcript of such trial was a part of the record in the proceeding in the District Court on the Petition for Review, and, of course, is a part of the record on this appeal.

Claimant (Appellee herein) is an attorney at law, with his office in Beverly Hills, California. He has been a member of the bar since 1943 and since 1947 has been specializing in the practice of bankruptcy and insolvency law. [Tr. 63.] Claimant became the holder of the subject payroll checks in the following manner:

The undisputed evidence disclosed and the Referee found that the bankrupt corporation, shortly prior to the commencement of the within proceedings, had issued a number of payroll checks to its employees which checks were either dishonored when presented at the bank or would have been dishonored if presented to the bank, and that Milo M. Turner, an officer, director and sole shareholder of the bankrupt corporation, personally obtained outside funds and used such money to "pick up" said payroll checks, the employees in each case endorsing such checks and delivering them to Milo M. Turner. On or about April 4, 1956 Milo M. Turner transferred and delivered to Appellee the subject checks in payment of a $1500.00 retainer of Appellee for legal services, which retainer had been demanded by Appellee before he would agree to assume the responsibility of becoming counsel for the purpose of representing the corporation in the preparation and filing on behalf of the corporation of a Petition for Arrangement under Chapter XI of the Bankruptcy Act and representing the corporation in the ensuing proceedings. Upon his employment by the corporation on April 4th and the receipt by him of such checks, Appellee did undertake the representation of the corporation and did prepare and file on behalf of the corporation proceedings under Chapter XI of the Bankruptcy Act, and represented the corporation throughout the subsequent debtor and bankruptcy proceedings.

(A most distorted picture of this part of the story is set forth by Appellant on the bottom of page 2 of his Opening Brief herein. Appellant states that the Chapter XI proceeding "proved abortive a few days subsequent to its filing and an Order of Adjudication was made and entered approximately four days after the filing of the

Chapter proceedings". The fact is that the Chapter XI proceeding was filed April 5, 1956; the adjudication in bankruptcy was under date of May 11, 1956 and filed May 15, 1956. [Tr. 13-14.] Other, but less material, inaccurate statements, assumptions and conclusions appear on the same page of Appellant's Brief.)

The Referee found and concluded that the bankrupt corporation is the *alter ego* of Milo M. Turner, that Milo M. Turner is generally liable for the debts of the corporation, that any claim that Milo M. Turner might have against the corporation should be subordinate in payment to the general creditors, and that Appellee as an assignee from Milo M. Turner, stands in no better position than Turner would in connection with the subject payroll checks; and on that basis the Referee allowed the subject claim in the amount of $1531.45 as a general unsecured claim only and further ordered and directed that said claim be subordinated in payment to the payment of all other general unsecured claims in the subject bankruptcy proceeding.

The Referee further concluded that the fee of Appellee was subject to determination and review by the Court under the provisions of Section 60d of the Bankruptcy Act, 11 U. S. Code, Chapter 6, Section 96d.

Appellee petitioned for a review of said Order of the Referee and said Petition for Review was heard and determined by the Honorable Irving R. Kaufman, District Judge. The District Court made an Order setting aside the Referee's Order and directing that Appellee's claim in the amount of $1531.45 should be accorded priority status and allowed as a prior claim in said amount. The District Court, adopting rather than disregarding the Referee's Findings of Fact, found error in the Referee's

conclusion that the bankrupt corporation is to be regarded as the *alter ego* of Milo M. Turner. The District Court concluded that the assignment of the wage claims was proper, valid and enforceable in the hands of Appellee. The District Court further found that as the payment to Appellee did not involve funds of the corporation, the Referee's determination that the attorney's fee is subject to review under Section 60d was erroneous. The analysis and conclusions of the District Judge are clearly set forth in his written opinion on file herein. [Tr. 33-39.]

The Trustee in bankruptcy, aggrieved by the Order of the "visiting Judge from New York" has filed this appeal which, in effect, asserts that the Referee was correct in the first place and that the District Court was in error in saying that the Referee erred.

Issues on Appeal.

The most basic issue in this matter is whether the Referee in bankruptcy properly concluded that the bankrupt corporation was the *alter ego* of Milo M. Turner at the time that Milo M. Turner paid cash for and took assignments of the subject payroll checks. The other issues as to the validity of the assignments of the wage claims and the question of whether the fee for legal services was paid from funds of the bankrupt corporation really turn upon a resolution of the first stated issue. If Milo M. Turner was not the *alter ego* of the corporation, then it must follow that the funds transferred to the employees in consideration of the assignment of their payroll checks were not funds of the corporation. The assignment of the wage claims would be clearly valid; and the question of review of legal fees under Section 60d would be irrelevant.

In the Appellant's Opening Brief (pp. 6-7) Appellant seeks to inject an issue which was never put into issue by the pleadings nor at the trial of the matter below: Appellant now asserts that the payments by Milo M. Turner to the wage claimants, "irrespective of equitable theory or *alter ego*", "amounted to capital contributions to the capital structure of the corporation and therefore cancelled such wage claims as against the corporation." (App. Br. p. 6.) This proposition is again asserted by Appellant in his "Summary of Argument" on page 7 of his brief where Appellant now assumes further that the corporation was "insolvent" at the time of the subject payments. Never before in this controversy was there an assertion that the corporation was insolvent at the time of the payments nor was there any testimony on this regard at the trial. The distortions, unwarranted assumptions and efforts to inject new issues may reflect Appellant's present awareness of the inadequacy of the trial record to support the conclusions of the Referee.

There is not at issue on this appeal the question or proposition that the Reviewing Court should accept as correct the Referee's Findings of Fact unless such Findings are clearly erroneous. Not only does this Appellee recognize the validity of such rule but the District Court below recognized such rule, and did not set aside the Referee's Findings of Fact. [See District Court's Opinion, Tr. 35.]

ARGUMENT.

I.

The District Court Was Correct in Disregarding the Conclusions Drawn by the Referee From the Facts as Found.

Appellant has no quarrel with the well-settled rule that the District Court should accept the Referee's Findings of Fact unless such Findings are clearly erroneous. However, the corollary to that rule is that if there is no substantial evidence to support it, the Referee's Findings will not be sustained.

In re Collins (S. C. Cal.), 141 Fed. Supp. 25.

It is equally clear that the designation as "Findings of Fact" of what in reality are Conclusions of Law, will not operate to limit the reviewing power of the higher Court.

In the instant case the Referee was not presented with any problems of contradictory witnesses or substantially conflicting testimony or evidence. The Referee did not have to weigh the credibility of one witness against the credibility of another. There are no substantial factual conflicts in the evidence presented to the Court. The issues herein arise upon the inferences and conclusions reached by the Referee from the evidence.

Such inferences and conclusions are not conclusive upon the reviewing Court; just as in other situations, the trier of fact should resolve disputed issues of fact, but questions of policy and limitations upon the privilege of incorporation are ultimately for the Appellate Courts to determine.

Ballantine, *Corporations: "Disregarding The Corporate Entity" As A Regulatory Process,* 31 Cal. Law Review 426;

Schifferman, *The Alter Ego,* 32 Cal. State Bar Jour. 143.

II.

The District Court Was Correct in Holding That the Evidence Presented Before the Referee Totally Failed to Support the Conclusion That Milo M. Turner Is the Alter Ego of the Bankrupt Corporation.

The Trustee in bankruptcy, Appellant herein, totally failed in the trial before the Referee in bankruptcy to present evidence of facts which would support a conclusion that the bankrupt corporation should be regarded as the *alter ego* of Milo M. Turner.

> ". . . it is incumbent upon the one seeking to pierce the corporate veil to show by evidence that the financial setup of the corporation is just a sham and accomplishes injustice."
>
> *Carlisimo v. Schwebel,* 87 Cal. App. 2d 482, 197 P. 2d 167.

The conditions under which the corporate entity may be disregarded, or the corporation regarded as the *alter ego of* the stockholder have been summarized in a number of California cases. In *Hollywood Cleaning & Pressing Co. v. Hollywood Laundry Service,* 217 Cal. 124, 17 P. 2d 709, the rules are summarized as follows in 217 Cal. at page 129, 17 P. 2d p. 711:

> "Whatever may be the rule in other jurisdictions, the rule is well settled in this state that the mere fact one or two individuals or corporations own all of the stock of another corporation is not of itself sufficient to cause the courts to disregard the corporate entity of the last corporation and to treat it as the *alter ego* of the individual or corporation that owns its stock. In addition it must be shown that there is such a unity of interest and ownership that the individuality

> of such corporation and the owners or owners of its stock has ceased; and it must further appear that the observance of the fiction of separate existence would, under the circumstances, sanction a fraud or promote injustice. Bad faith in one form or another must be shown before the Court may disregard the fiction of separate corporate existence."

In *Norins Realty Company v. Consolidated A & T Co.,* (1947), 80 Cal. App. 2d 879, 182 P. 2d 593, the Court held that the allegations of the complaint were insufficient to support a cause of action by a creditor to disregard the corporate entity and support a judgment against the individual defendants. The Court stated that:

> "Mere ownership of all the stock and control and management of a corporation by one or two individuals is not of itself sufficient to cause the Courts to disregard the corporate entity."

In the *Norins Realty* case the plaintiffs, attacking the corporate entity, were demurred out of Court, though their complaint alleged substantially more on the subject than the Trustee produced herein by way of evidence.

It is pertinent to relate the general and accepted rules on the question of disregarding the corporate entity to the evidence presented by the Trustee at the trial below. A study of the entire transcript of the hearing in this matter discloses the following as the total evidence on the point in question:

(1) Immediately prior to the bankruptcy, Turner was the only *active* officer in Zipco, Inc. the bankrupt corporation. [Tr. 45-46.]

(2) Turner was the sole shareholder of Zipco, Inc. [Tr. 46.]

(3) Turner gave personal guarantees to two or three creditors of Zipco, Inc. [Tr. 48.]

(4) Turner was the "responsible" officer of the corporation. [Tr. 53.]

Turner was the sole shareholder of the bankrupt corporation, and the inference is fair, as in any similar situation, that his was substantially the controlling voice in the affairs of the corporation. The mere fact that all of the corporate stock is held by one person and that said person exercises control over the corporation has never been regarded as sufficient to justify disregarding the separate corporate entity. There is absolutely no evidence of improper domination by Turner. There is no evidence that the corporation was the instrumentality of Turner for his individual use and benefit. There is no evidence that a failure to pierce the corporate veil would sanction fraud or promote injustice.

On the basis of the record in this case, the District Court had no choice but to hold that the Referee committed error in concluding that the evidence presented at the hearing supported a conclusion that Milo M. Turner was the alter ego of the bankrupt corporation.

Appellee, in his petition on review to the District Court herein, had complained of other errors on the part of the Referee which the District Court, because of its holding on the major points, apparently did not feel it necessary to cover in its opinion. Yet it should be here noted that it has been the position of Appellee ever since the opening of the hearing before the Referee that it was error for the Referee to admit into evidence, over the continuing

objection of Appellee, testimony relating to the question of whether the bankrupt corporation was the *alter ego* of Milo M. Turner.

The Trustee's written objections to the claim in this proceeding gave claimant no indication whatsoever that at the hearing on such objection he would be faced with the legal proposition that Milo M. Turner was the *alter ego* of the bankrupt corporation and that upon such basis the claimant's assignor (Turner) could not file such prior claim based upon the assigned payroll checks. The Trustee did not disclose this basic theory until he commenced, at the hearing herein, the examination of his first witness Milo M. Turner. [See Tr. 46-48.] As indicated in the transcript claimant immediately and fully presented his objection to such line of questioning, which objection was overruled by the Referee. After waiting a full twelve months to file objections to a priority claim, a Trustee in bankruptcy has a minimum duty of advising the claimant the real basis of his objections to the claim. While the Trustee's objection stated a number of bases for the objection, the real objection—the one upon which the Trustee relied and upon which the Referee based his Findings and Conclusion, is the one objection totally omitted from the Notice of Hearing of Objections given to claimant herein.

It is fundamental that evidence must be relevant to the issues in a case before it can be admitted. While the District Court held that the subject testimony was inadequate to support the conclusion of *alter ego,* it should further be noted that the Referee's erroneous conclusion was in itself based upon improperly admitted testimony.

III.

Assignment of Wage Claims.

A. Any Claim for Wages Earned Within Three Months Preceding Bankruptcy That Is Entitled to Priority Under the Provisions of Section 64a (2) May Be Freely Assigned and Will Carry With It Into the Hands of the Assignee the Same Priority It Had in the Hands of Its Original Owner.

This matter is discussed in 3 Collier on Bankruptcy (14th Ed.), pages 2096 and 2097.

The above doctrine was first laid down by the United States Supreme Court in 1907 in the case of *Shropshire Woodliff and Co. v. Bush,* 204 U. S. 186, 27 S. Ct. 178, 51 L. Ed. 436. In upholding a prior wage claim in the hand of an assignee the Supreme Court stated:

> "When one has incurred a debt for wages due to workmen, clerks, or servants, that debt, within the limits of time and amount prescribed by the act, is entitled to priority of payment. The priority is attached to the debt, and not to the person of the creditor; to the claim, and not to the claimant. The act does not enumerate classes of creditors and confer upon them the privilege of priority and payment, but, on the other hand, enumerates classes of debts as 'the debts to have priority' ".

B. The Assignment of a Wage Claim to Stockholder of a Bankrupt Corporation Is Valid and Enforceable As a Prior Wage Claim.

The Court of Appeals for the Seventh Circuit had the occasion in 1942 to deal directly with issue presented where prior wage claims were filed in the bankruptcy proceeding of a corporation by a group of stockholders of the bankrupt corporation, said claims having been assigned to the

stockholders by certain of the employees. (*In re Dorr Pump and Mfg. Co.* (CCA 7-1942), 125 F. 2d 610.)

The *Dorr* case arose in Wisconsin, where after bankruptcy, some of the employees of the bankrupt corporation were threatening to file suit against certain stockholders on the basis of individual liability of the stockholders for wages, pursuant to Wisconsin law. A group of the stockholders made payment to the employees of the amount of their claims for services and at the same time took an assignment of such wage claims. The stockholders then filed such assignments as prior wage claims against the corporation in the bankruptcy proceedings. The claims were allowed as priority claims and the Trustee appealed. The Trustee contended that since the debt to the employees was paid, there was nothing to assign, and further that the payment to the employees was the discharge of a primary obligation of the stockholders and there could be no subrogation of the stockholders to the rights of the wage earner.

The Circuit Court affirmed the allowance of such claims and held that the legal effect of the payment to the employees of the money and their receipt of the assignment was not to extinguish the debt but to assign it to the stockholders, and that such assignment was valid. The fact that the stockholders, under Wisconsin law, had a personal liability to the wage earners, did not deter the Court from its conclusion. The Court noted that the stockholders owed nothing to the corporation or to its non-wage earning creditors under such law. Such statute was obviously for the benefit of the wage earners and "not for the purpose of creating additional assets or credits to which other creditors had a right to look." (At page 611.)

Appellant's arguments on the matter of assignment of wage claims and also on the subject of *alter ego* include the presentment of material facts not in evidence and the drawing of inferences from such "facts". This, in connection also with question-begging argument has a tendency to lead the discussion of issues off the pertinent track. Throughout Appellant's Opening Brief he makes reference to the corporation's "insolvency", refers to Turner's "full knowledge of its insolvent financial condition" (App. Br. p. 11) and generally discusses the bringing in of outside cash by Turner for the payment of payroll checks of the corporation's employees as though it were a dastardly deed done with the most evil of intent and with the design of making some profit from such act as against the creditors of the corporation. It was indeed obvious that the corporation was in a poor cash position at the time in question, not being able to meet its payroll. However, nowhere during the hearing was there testimony to the effect that the corporation was insolvent. On the contrary the only testimony relating to assets and liabilities was a reference to a balance sheet of February 29, 1956 which indicated a solvent condition showing total assets of $244,526.14 and total liabilities of $204,-324.00. [Tr. 69.]

The uncontradicted testimony at the trial of this matter presents the following "sinister" background of the transfer by Turner to Appellee of the subject wage checks: Turner, identifying himself as President and major shareholder of the corporation, came to Shutan somewhere around April 1, 1956 having been recommended to the latter as a specialist in insolvency and Chapter XI proceedings. In the initial discussion of the corporate problems the matter of a cash advance payment as a retainer

to Shutan for his legal services was discussed. A figure of $1500.00 was arrived at. Turner stated that the corporation was short of cash but that he would try to raise the money from personal and private resources. [Testimony of Milo M. Turner, Tr. 50; testimony of Robert H. Shutan, Tr. 64.] Turner did raise a sufficient amount of cash from personal sources, but was disturbed about the outstanding unpaid payroll checks. Turner took this cash and "picked up" the subject payroll checks, getting endorsements from the employees. Turner then prevailed upon Appellee to take an assignment of the subject payroll checks, in lieu of the actual cash, as the required retainer. On April 4, 1956 subject checks were transferred and assigned by Turner to Shutan and Turner signed a written assignment of same [Claimant's Ex. No. 1, Tr. 55], in which Turner represented that each of the employees had been paid the full face amount of such check and has endorsed such check in consideration for the payment and that none of the moneys used in the payment of said checks constituted funds of the corporation but on the contrary that all of said checks were paid from Turner's personal funds. Thereupon, Appellee assumed the responsibility of representing the subject corporation (which appeared to have assets of almost a quarter of a million dollars and liabilities of approximately $204,000.00) and guiding such corporation through a Plan of Arrangement under Chapter XI of the Bankruptcy Act. Appellee, in his testimony before the Referee, summarized the services which he thereupon rendered on behalf of the corporation. [Tr. 66-78.] Appellee takes personal umbrage at the remarks of Appellant appearing at the bottom of page 14 and the top of page 15 of Appellant's Opening Brief, which remarks seek vaguely to imply some participation by Appellee with Mr. Turner

in something less than a completely proper activity. The uncontradicted record demonstrates that Turner and the corporation were utter strangers to Appellee until the occasion of the subject employment of Appellee as counsel.

Appellant's discussion of Section 60d of the Bankruptcy Act completely begs the question herein. The reference to an "attorney induced device" . . . "to circumvent Section 60d" is as unjustified as it is illogical.

When before the District Court (as here also), Appellant raised the question of whether allowance of the claim would indicate approval and sanction an undesirable method of obtaining attorney fees. This question can be answered by another question: Is it inequitable or in anyway improper for an attorney, with no previous contact with or obligation to a prospective client, to say to that client, "Though it is the firm policy of my office to require a cash retainer before assuming the responsibility of representing a debtor in Chapter XI proceedings, it will be acceptable to me for you to take the cash you have raised personally and use it to pick up payroll checks of your corporation's employees; I will accept assignments of such payroll checks and wait, instead of the employees, for the payment out of the debtor proceeding."?

If Appellee received funds of the bankrupt corporation as the retainer fee for the legal services in the preparation and filing of the Chapter XI proceedings there is no question but that such fee is subject to review by the Referee under Section 60d. It is just as simple as stating it. No fees will be charged a prospective debtor or bankrupt and paid for out of the assets of said debtor or bankrupt without creditor protection and court scrutiny. On the other hand, if the funds used to employ counsel

do not come from the bankrupt, either directly or indirectly, Section 60d simply does not apply.

Appellant, in his argument on page 13 of Appellant's Opening Brief, argues that Turner because of his relationship to the bankrupt corporation (and Appellant further assuming the *alter ego* theory) could not have successfully filed a prior wage claim in the bankruptcy proceeding for his own services to the corporation—and then Appellant extends this even further to conclude that therefore certainly Turner couldn't have successfully filed the subject prior wage claims in this proceeding. Aside from the false assumptions, the argument illustrates Appellant's complete failure to distinguish between a "wage claimant" and an "assignee of a wage claim". It is quite conceivable that there would be situations where an officer-director-shareholder of a bankrupt corporation would be denied priority on a claim filed for his own salary; yet this again has nothing to do with the rights of an otherwise valid prior wage claim filed by an officer of the corporation as an assignee of said claim. See *Dorr Pump and Mfg. Co., supra,* 125 F. 2d 610.

Conclusion.

If the moneys used to pay the subject payroll checks were not funds of the bankrupt corporation then all of the arguments of Appellant fall assunder. On what basis can Appellant show that the funds were those of the corporation?

1. That the subject funds came directly or indirectly from the corporation's cash or other corporate assets? The Trustee in bankruptcy, Appellant herein, never even attempted to show this. There is no evidence of any kind whatsoever to indicate the affirmative on this question.

2. That Milo M. Turner was the *alter ego* of the bankrupt corporation and that therefore Milo M. Turner's funds, used herein, were the same as the corporate funds? The District Court was clearly correct that the evidence presented at the trial of this matter before the Referee, and the facts as found by the Referee, cannot support the conclusion that Milo M. Turner was the *alter ego* of the bankrupt corporation.

It follows therefore that claimant (Appellee) holds a valid assignment of an enforceable prior wage claim and is entitled to have such prior wage claim allowed as such in this proceeding.

It also follows that the District Judge was correct in holding that, as the assignment to claimant of said wage claims did not involve funds of the corporation, such attorney's fee is not subject to review by the Court under Section 60d.

It is therefore submitted that the Order of the District Court should be affirmed in all respects.

Respectfully submitted,

ROBERT H. SHUTAN,

Attorney for Appellee.